REA BOOKKEEPING COURSE

Text No. 2

Theory of Debits and Credits

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UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration
Finance Division

THEORY OF DEBITS AND CREDITS

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1. INITIAL BOOKKEEPING ENTRIES

The system of recording money values in bookkeeping is based primarily upon the use of two columns: a left-hand or "debit" column, and a right-hand or "credit" column. The theory of debit and credit is derived from the accounting equation, previously referred to.

(Left) Assets = Liabilities + Capital (Right)

Initial Entry	xx			xx		xx
Transactions	+	-	-	+	-	+

The various assets invested in or acquired by a business are entered as debits. All liabilities outstanding are entered as credits, and the balancing element of capital as a credit. Thus, amounts recorded in left and right columns must always balance, establishing equilibrium--debits equal credits.

In the book of final entry, called the general ledger, debit and credit columns for money (with other columns for date, explanation of posting, and reference, which will be illustrated later) are provided for each kind of asset or liability, and capital. These are called "ledger accounts." Referring to the Statement of Asset, Liabilities, and Capital for John Smith given in Section 9 of Text No. 1, the accounts would appear in the ledger as follows:

Cash		Building		Mortgage Payable	
(Debit)	(Credit)	(Debit)	(Credit)	(Debit)	(Credit)
$8,000		$7,500			$5,000

Government Bonds		Land		John Smith, Capital	
(Debit)	(Credit)	(Debit)	(Credit)	(Debit)	(Credit)
$2,000		$2,500			$15,000

The total assets (debited), $20,000, equal the liability and capital items (credited), $20,000. Note that each pair of columns, or account, is given a title and classified in accordance with the information contained therein.

The initial entry setting up these values was made in a book of original entry called the "journal", The essential features of a journal are a set of

money columns and space for account titles and explanations (other columns for date and reference will be illustrated later):

July 1, 1939

(Account Titles and Explanations)	(Debit)	(Credit)
Cash	$8,000	
Government Bonds	2,000	
Building	7,500	
Land	2,500	
Mortgage Payable		$ 5,000
John Smith, Capital		15,000
Investment in business.		

The procedure in opening a double entry set of books is: (1) prepare the statement of assets, liabilities and capital in order to determine the net assets or capital invested: (2) make the initial entry in the journal, using the statement as a basis by debiting assets and crediting liabilities and capital; (3) open ledger accounts using titles as indicated by the journal entry. Note, that the journal shows the investment as a transaction, while the ledger accounts separate assets, liabilities and capital according to classification or kind.

After the above totals have been transferred from the journal to the various accounts in the general ledger and a balance effected, how is this balance maintained in recording subsequent business transactions? The answer is that every exchange of values may be analyzed into its effect upon assets, liabilities, or capital; and, under the double entry system of bookkeeping, for every debit there must be a corresponding credit. Thus total debits and credits will remain equal.

Debits and credits in the individual accounts are totaled and the difference arrived at or offset in order to find the excess, or net amount, which is referred to as the account balance. The individual accounts, therefore, may be thought of as showing additions to or subtractions from the amounts originally entered.

Referring to the diagram first given, it can be seen that assets are originally debited; therefore to increase an asset account we must debit and to decrease it we must credit. Liabilities and capital are originally entered as credits; therefore increases in these items are credited and decreases are debited. The rules of debit and credit may be summarized as follows:

DEBIT:		CREDIT:	
	Increases of Assets		Decreases of Assets
	Decreases of Liabilities		Increases of Liabilities
	Decreases of Capital		Increases of Capital

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The recording of business transactions will be discussed in Texts Nos. 3 and 4. We now turn to a more detailed illustration of the procedure followed in opening a double entry set of books.

2. PRIMARY BOOKS OF ACCOUNT

The only books of account that are absolutely necessary in order to set up a double entry bookkeeping system are the journal and the general ledger. It is true that other subsidiary records of various kinds are generally required; but inasmuch as double entry bookkeeping can be explained clearly in terms of the simple journal and general ledger, the introduction of any other type of record at this time would tend to confuse the reader.

3. THE JOURNAL

The journal is known as a book of original entry because it is the first book in which transactions are recorded in accounting form. There are many types of journals, but at present we are interested only in the simplest type--a bound book, the pages of which are numbered consecutively and ruled in accordance with a standard form. The page of a simple journal appears as follows:

(Journal)
(Page 1)

January 2, 1939

(Date)	(Name of Accounts and Explanation)	(Folio)	(Debits)	(Credits)
	Notes Receivable	2	100 00	
	John Jones	4		100 00
	Settlement of customer's account for 60-day note.			
	- 2 -			
	Richard Smith Company	7	50 00	
	Cash	1		50 00
	Payment of balance due creditor			
	- 3 -			
	Furniture and Fixtures	6	55 00	
	Cash	1		55 00
	Purchase of one oak desk.			

Study this form and observe the manner of recording: (1) the name of each account is recorded on a single line; (2) debits are written first followed on the next line by credits, indented; (3) each journal entry is followed by an explanation of the transaction; (4) the date of entry is placed near the middle of the explanation column above the transactions occurring on a given date; (5) the month and year are shown only once on each page; (6) the entries are recorded in chronological order; (7) the folio or page column indicates the number of the general ledger page to which debit and credit items are posted.

Note that the columns to the extreme left have not been used. Some bookkeepers utilize these for recording the date of each transaction. While this is proper, it is generally considered better practice to place the date above each transaction in order to separate the entries.

When a transaction occurs, it should be analyzed as to its debit and credit elements and recorded in the journal. All transactions will then follow one another in chronological order in the journal.

The recording of a transaction in accounting is known as the "journal entry". Each journal entry must balance; that is, the debit elements must exactly equal the credit elements in order to maintain the balance established in double entry bookkeeping. Bear in mind that every transaction involves an offsetting debit and credit and can be expressed in the form of a journal entry, thus:

(Date)		
Cash	$500.00	
Notes Receivable		$500.00
Collection of Tom Brown's note.		
(Date)		
Delivery Truck	850.00	
Cash		250.00
Notes Payable		600.00
Truck No. 123456, 90-day 6% note given to Motor Company.		

The above entries show that for every debit there is a supporting equal credit. The first entry is called a simple entry because it contains only one debit and one credit item. If either the debit or credit element involves more than one account, the entry is known as a compound entry.

It is generally accepted practice to post entries from the journal to the general ledger at the close of a calendar month. Posting consists of transferring each debit and credit item from the journal to the appropriate general ledger account. After an entry is posted, the bookkeeper should insert in the journal column marked "Folio" the page number of the general ledger account involved, and indicate in the general ledger account, the page number of the journal in which the entry is recorded. This is essential for cross-reference purposes.

4. THE GENERAL LEDGER

The general ledger is described as a book of final entry because the debits and credits originating in the journal are transferred to the ledger accounts by the process of posting. The general ledger, because it contains all accounts, is also referred to as the "book of accounts." General ledgers, like journals, have many variations; but for the purpose of this text we

shall consider only the simplest type, that is, a bound volume, the pages of which are numbered consecutively and ruled in accordance with a standard form. A general ledger sheet, showing the use of the various columns, is illustrated below:

(Ledger)
(Page 1)

Cash Account

(Date)	(Explanation)	(Folio)	(Debit)	(Date)	(Explanation)	(Folio)	(Credit)
1939				1939			
Jan 1	Balance		568.15	Jan 2	R. Smith Co.	1	50.00
4	Tom Brown	2	500.00	3	Furniture	1	55.00
				5	Truck	2	250.00

The explanation column is provided in order that a brief description may be given of each debit and credit item posted to the account. Whether the explanation column should be used is a question upon which authorities differ; some think it is unnecessary to use it at all, others believe that it is better to show brief explanatory data. The latter seems the better view because if explanations are given, the composition of the account can be ascertained without referring back to journal entries for information.

Because of the fairly complex nature of the books of account used in REA bookkeeping it appears particularly important to make full use of the ledger sheet explanation column, thus reducing the frequency with which transactions must be traced for reference purposes to the various books of original entry.

The general ledger account has the outline of the letter "T" and may be visualized as a frame into which the various debit and credit items of similar kind or classification are set. Each ledger account may be given one or more pages, depending upon the number of items the account may have to accommodate over a period of time. The inclusion of more than one account on a page is not considered good practice.

Each debit and credit amount is recorded twice. The transaction is first entered in the journal as previously explained, then posted to the general ledger where all debits and credits of like kind are brought together in one place in the form of an account. All debits and credits, for example, relating to the asset classification of "Notes Receivable" will be posted to the ledger account of that title.

Up to this point we have considered in some detail the form and use of the general ledger account. Now let us consider briefly some of its mechanical functions in the light of double entry accounting theory.

The first rule for debiting reads, Debit: Increases of Assets. This suggests the question as to why we debit to increase assets. The answer is that since every asset normally has a debit balance, we must debit in order to increase that balance. To illustrate this, suppose that the account for Furniture and Fixtures shows a balance of $275.00. Then a desk is purchased for $55.00. The purchase of this desk means that the asset "Furniture and Fixtures" has been increased. In order to give effect to this increase, the Furniture and Fixtures account must be debited with the amount of the purchase.

Furniture and Fixtures

Jan. 1	Balance	$275.00	
3	Oak desk	55.00	

If this account were credited, such an entry would have a decreasing effect upon the asset; in other words, the asset account would be reduced. This illustration is given to demonstrate the increasing and decreasing effect of debits and credits upon a particular general ledger account. Note that if we had been considering a liability or capital account--which normally has a credit balance--a credit would have an increasing effect, whereas a debit would have a decreasing effect.

With this in mind, the general ledger account has been defined as an account showing on the one hand all the increasing effects on the total amount of the account, and on the other hand all the decreasing effects on the total amount of the account, resulting from transactions which have occurred during a given period. Therefore, when it becomes necessary later on to apply the rules for debiting and crediting, the reader may think of an account as a medium for applying the mathematical process of addition and subtraction.

5. THE OPENING JOURNAL ENTRY

Suppose that Dan Ross, conducting a small trading business and maintaining no standard books of account, decides to install a double entry bookkeeping system. He has obtained the two necessary books--journal and general ledger--and proposes to establish his records on a double entry basis. His first step will be to determine (1) what he owns, (2) what he owes, and (3) the amount of his capital or net worth at the present time. In other words, he must prepare a Statement of Assets, Liabilities, and Capital, as follows:

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Dan Ross
Statement of Assets, Liabilities, and Capital
As of January 1, 1939

Assets			Liabilities		
Cash		$ 1,000	Accounts Payable:		
Accounts Receivable:			Victor Leads	$ 750	
John Doe	$ 500		Sam Burns	250	$ 1,000
Frank Brown	1,000	1,500	Notes Payable (O.C.White)		2,000
Merchandise Inventory		2,500	Mortgage Payable (C.R.Co.)		1,000
Furniture and Fixtures		500			
Building		5,000	Net Worth		
Land		1,000	Dan Ross, Capital		7,500
		$11,500			$11,500

Study this statement and observe how the accounting equation applies to the elements of which it is composed. As this principle runs all through accounting theory, it will bear repetition. The above statement shows:

$11,500 Assets = $4,000 Liabilities + $7,500 Capital

With the information contained in the statement of financial condition for Dan Ross, he is ready to make the opening journal entry as follows:

January 1, 1939 (Journal - Page 1)

			Debit	Credit
	Cash	1	1,000.00	
	John Doe	2	500.00	
	Frank Brown	3	1,000.00	
	Inventory	4	2,500.00	
	Furniture and Fixtures	5	500.00	
	Building	6	5,000.00	
	Land	7	1,000.00	
	Victor Leads	8		750.00
	Sam Burns	9		250.00
	Notes Payable	10		2,000.00
	Mortgage Payable	11		1,000.00
	Dan Ross, Capital	12		7,500.00
	To record the assets, liabilities, and capital of Dan Ross at Jan. 1.			

The opening journal entry has been made and Dan Ross now has his financial condition expressed in the language of accounting. Observe that he has debited assets and credited liabilities and capital. Each asset item will be posted to

the debit (left) side of an appropriate general ledger account and each liability and capital item will be posted to the credit (right) side of an appropriate ledger account.

Referring to the rules for debiting and crediting presented in Section 1, attention is directed to the fact that the accounts are not debited and credited in the opening entry on the theory that there is any increase or decrease, because obviously there were no accounts on the books prior to this entry. Why then were assets debited and liabilities and capital credited? The answer is that by custom, or usage, we start out in conformity with the equation, Assets = Liabilities + Capital. In the beginning we agree that assets have debit balances and liabilities and capital credit balances. This is an arbitrary procedure, the effect of which is to set up the accounts in such manner that we can weigh the assets (which always have debit balances) on the left side against liabilities and capital (which always have credit balances) on the right side. Therefore, in applying the rules of debit and credit it may be more nearly correct to say that those rules do not apply to the opening entry but that they do apply to all subsequent entries for business transactions.

It may be worth while to reverse the fundamental equation and express the same facts. Suppose the opening entry were made to conform to the equation, Liabilities + Capital = Asset: It would still be possible to keep a double entry set of books in an unconventional way by forming rules of debit and credit directly the opposite of those given. The important thing to keep in mind when applying the rules of debit and credit in double entry bookkeeping is that we must have an equation weighing assets on the one side and liabilities and capital on the other.

6. POSTING THE INITIAL JOURNAL ENTRY TO THE GENERAL LEDGER

Dan Ross will now post the information that has been recorded in the journal to the ledger, using account titles as given in the initial entry:

Cash (Page 1)

1939 Jan.	1	Investment	J1	1	000	00				

John Doe (Page 1)

1939 Jan.	1	Balance	J1		500	00				

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Frank Brown (Page 3)

1939							
Jan. 1	Balance	J1	1 000 00				

Inventory (Page 4)

1939							
Jan. 1	Investment	J1	2 500 00				

Furniture and Fixtures (Page 5)

1939							
Jan. 1	Investment	J1	500 00				

Building (Page 6)

1939							
Jan. 1	Investment	J1	5 000 00				

Land (Page 7)

1939							
Jan. 1	Investment	J1	1 000 00				

Victor Leads (Page 8)

				1939			
				Jan. 1	Balance	J1	750 00

Sam Burns (Page 9)

				1939			
				Jan. 1	Balance	J1	250 00

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Notes Payable (Page 10)

				1939			2x0
				Jan. 1	O. C. White		2 000 00

Mortgage Payable (Page 11)

				1939			
				Jan. 1	C. R. Co.	J1	1 000 00

Dan Ross, Capital (Page 12)

				1939			
				Jan. 1	Investment	J1	7 500 00

All posting now has been completed; that is, every debit and credit appearing in the journal entry has been transferred to the ledger. It will be noticed that the sum of the asset accounts with debit balances equals the sum of the liability and capital accounts' credit balances.

In order to demonstrate this fact clearly, the ledger accounts just set up will be displayed more compactly in the form of "T" accounts (these are often used when working problems to represent ledger accounts):

Assets (Debit Balances)

Cash	
1 000	

John Doe	
500	

Frank Brown	
1 000	

Inventory	
2 500	

Liabilities and Capital (Credit Balances)

Victor Leads	
	750

Sam Burns	
	250

Notes Payable	
	2 000

Mortgage Payable	
	1 000

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Assets (cont.)

Furniture and Fixtures

500	

Building

5,000	

Land

1,000	

Liabilities and Capital (cont.)

Dan Ross, Capital

	7,500

Compare the above graphic representation of the ledger with an ordinary set of scales or balance. If we place two equal weights on the scales, these weights will exactly counterbalance each other. The values set up in the ledger may be likened to the weights. We have a group of values on the left side of certain ledger accounts that exactly equals another group set up on the right side of other ledger accounts. The question now is, how long will the ledger remain in balance after business operations begin? If each transaction is correctly analyzed and the proper journal entry made and posted, the balance originally established will always remain constant. The journal entry controls the equilibrium of debits and credits, maintaining the balance. This will be illustrated in the following text by journalizing several of the basic transactions of a going business concern.